15.03 Earnings Per Share: Treasury Stock Method

3 - The Treasury Stock Method

The effect of **options** on diluted EPS is to first increase the shares by the number that would have been issued if the options had been exercised, then decrease the shares by the number that could have been repurchased by the corporation (at the **average CS market price** during the year) with the proceeds from exercise. This is known as the **treasury stock method.** The exercise of options has no effect on earnings since options pay no dividends or interest. If market prices change in the future, previously reported EPS should not be adjusted retroactively, leave it as it was reported.

For example, if 40,000 options are issued at an option price of $15 per share when the average market price is $20 per share, what is the dilutive effect?

40,000 options which are convertible into 40,000 shares of C/S
× $15 option price
$600,000

600,000/$20 avg. mkt price = 40,000
− 30,000 shares of treasury stock
10,000 shares dilutive effect

Another method of calculating the *incremental number of shares outstanding* is:

$$\text{Number of shares} - \frac{(\text{Number of shares} \times \text{Exercise price})}{\text{Average market price}} = \text{Additional shares outstanding}$$

$$40{,}000 - \frac{(40{,}000 \times \$15)}{\$20} = 10{,}000$$